Confidential

Intelligence Report

Indonesia: Recent Changes in Fortune

Confidential

ER IR 75-10

April 1975

Copy № 71

Approved For Release 2005/01/10 : CIA-RDP86T00608R000500200011-4

Approved For Release 2005/01/10 : CIA-RDP86T00608R000500200011-4

Indonesia:
Recent Changes in Fortune

In the last few years, Indonesia has shifted from heavy dependence on foreign financial aid to a position of relative financial independence. High world prices, particularly for oil, pushed exports to the US $3 billion mark in 1973, contributing to a gain of more than $200 million in foreign exchange reserves. The performance in 1974 was even better as oil brought the Indonesians $2.2 billion, and their exchange reserves rose to some $1.5 billion.

Accompanying the strong foreign sector gains was real annual growth on the order of 8%-10% during 1973-74. This surge beyond earlier average rates of 6%-7% came from a combination of improved agricultural performance, increased oil output, contract revisions that allow Indonesia to keep more of the gains from oil, and the related stimulus to other sectors.

Although living standards have doubtless improved, oil revenues have yet to be translated into major development gains for most Indonesians. The majority of them live on Java in crowded urban slums or farms too small to support the average family. While there is great potential for increasing agricultural yields and farm incomes over the longer term, only limited progress has been made in this area so far. The result has been a large-scale migration to urban areas, where jobs are still relatively scarce and living conditions poor. Many of the resulting social problems and political pressures have been difficult for the Suharto government to control.

More rapid inflation has recently begun to distort economic and social progress. The Indonesians had ample experience with inflation during the 1960s and have carried through effective stabilization programs, but the institutional base for controlling rapid increases in the money supply and prices is still weak. In 1973, prices rose more than 30%; in 1974 new monetary and fiscal regulations failed to keep inflation below 40%.

25X1

25X1 Note: Comments and queries regarding this report are welcomed. They may be directed to [redacted] the Office of Economic Research, [redacted] 25X1
[redacted]

Notwithstanding the serious social and economic problems Indonesia faces, the outlook for rapid gains over the rest of this decade is generally good. No significant increase in foreign earnings is expected in 1975. Barring a sharp downturn in oil prices, however, export revenues should thereafter rise steadily as the developed world recovers from the current recession. These earnings, combined with moderately increasing net capital inflows, would amply cover financial capital requirements for national output growth on the order of 7%-9%.

DISCUSSION

Introduction

1. For the first time in modern history, Indonesia has begun to show some of the growth its large resource base has long portended. The legacy of aid clientism appears to be at end, but there are signs of other pressures that could threaten the stability of government. An understanding of these new directions and pressures requires some perspective on key economic events since the mid-1960s. Drawing on that base, this report focuses on the surge in growth in 1973-74 and considers Indonesian development needs and prospects in the coming years.

Recent Economic Experience (1967-72)

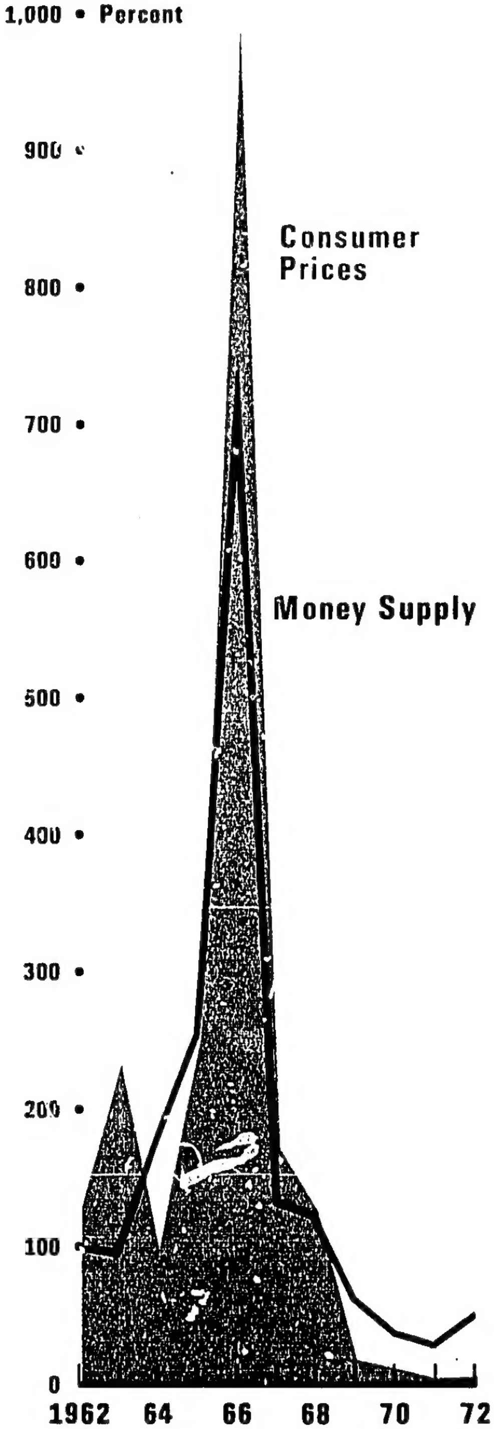
2. The Sukarno era left the Indonesian economy with much to overcome. Particularly during the period of "guided democracy" (1954-65), when development was subordinated to political and military objectives, Indonesia's economic performance was poor compared with that of other LDCs. Although others faced similar obstacles to growth because of inflation and large international payments deficits, conditions in Indonesia were especially severe, as average real incomes declined. The effects of this decline were sharpened by the population pressures on Java, the third most densely populated large area in the world.

3. The abortive Communist coup of 1965 and subsequent fall of the Sukarno regime provided the sort of clean break with the past that allowed the introduction of completely new economic policies. Urged by creditors and international organizations, the new administration of General Suharto embarked on a major stabilization program and began relaxing some of the controls that had hobbled the private sector. In a buoyant world economy, results were not long in coming. During 1966-72, inflation slowed from an annual rate of almost 1,000% to a low of 4% (see Figure 1). In the same period, real GNP growth climbed to an average of 6%-7% per year, compared with less than 3% in the early 1960s (see Figure 2). Gross investment as a share of GNP, encouraged by stability and government incentives, rose gradually to reach 17% in 1972, more than double the share during the Sukarno era (see Figure 3).

Engines of Growth

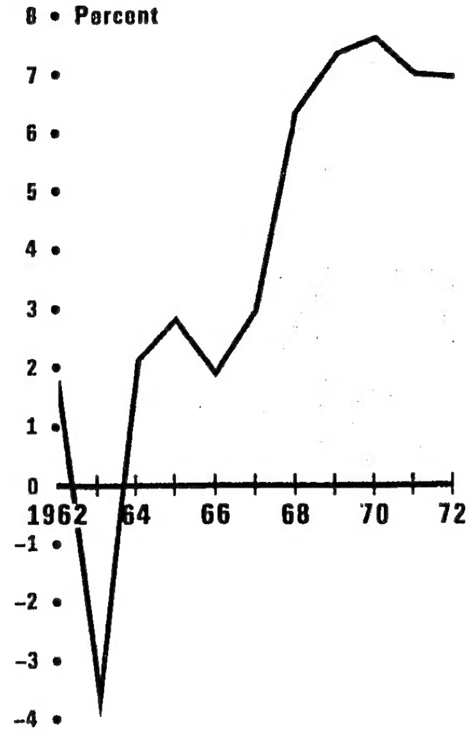
4. Financial stability was the first priority for Suharto's new government. The budget was balanced in 1967, largely because of improved revenue collection

Indonesia: Growth of Money Supply and Consumer Prices FIGURE 1



585515 4-75

Indonesia: Growth of GNP FIGURE 2

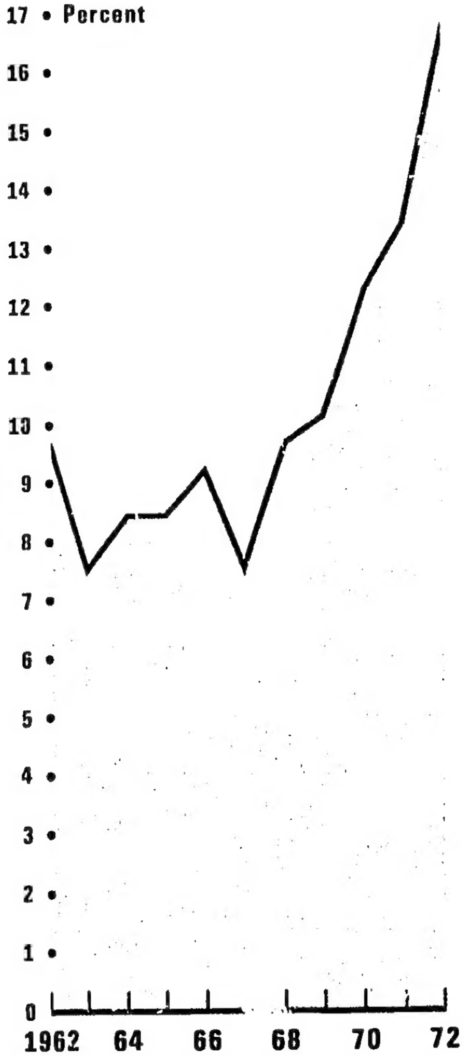


585516 4-75

and the move to put responsibility for its preparation and implementation in the hands of a single government agency. Credit tightened as interest rates were raised to 9% monthly instead of annually. As a result, the money supply grew only 130% in 1967, compared with nearly 750% in 1966, and its growth continued to taper off through 1971.

5. Determined to give the market a chance to work, Suharto adopted a general policy of decontrol at the same time. Price controls were limited to a few basic commodities, and quantitative import restrictions were virtually eliminated. Import tariffs were raised, and the export tax lowered. Concurrently, the

Indonesia: Investment as a Share of GNP FIGURE 3



565517 4-75

fixed exchange rate system was replaced by a simpler, more flexible multiple-rate system to help discourage less essential imports and encourage exports. A new law granted liberal incentives and assurances to foreign investors, and foreign properties nationalized in 1965 were returned to their owners. State industries, previously enjoying favored access to foreign exchange and subsidized credit, were forced to rely more on their own resources for rehabilitation and expansion. Further interest rate reform in 1968 brought about a rapid increase in time deposits in state banks.

6. These policies restored confidence for both domestic and foreign businessmen, a point that could soon be observed in key economic data series. Wholesale price increases, which earlier had reflected the strong drive to hoard goods, began to taper off only a year after the major stabilization measures were introduced, and the relevant price index actually declined in 1969. Domestic investment jumped 40% in 1968 and continued to grow more than 20% annually for the rest of the period. In 1968, after several years of stagnation, direct foreign investment began an upward trend. Foreign creditors once again began to believe that the Indonesians could service larger amounts of debt, and official long-term loans began a steady climb in 1967, with an increase for that year alone of $130 million.

7. Renewed domestic stability coincided with a world boom that eased the way for Indonesia to expand its exports nearly 15% annually during the period, an above-average performance for LDCs in this stage of development. Thus, the export sector, which included traditional agricultural products as well as the more aggressive petroleum industry, was able to make an exceptionally strong contribution to GNP growth.

Evolution of National Policy

8. With more rapid growth, economic policies were directed at improving domestic stability, international payments, and some institutional shortcomings. Reflecting the pressures of creditors (who had agreed to massive debt rescheduling) and the conservative philosophy of IMF advisers, economic policies tended to stress international solvency and domestic credit restraint. This financial conservatism, however, often meant limited support to such "unknown" risks as the farmer or small businessman.

9. Although economic policies did not deal directly with increasing incomes in the agricultural sector (where most Indonesians are employed) or with providing jobs for the growing urban population, some limited progress was made in these areas. In keeping with its policy to increase foreign exchange revenues, the government encouraged traditional agricultural exports, which benefited farmers who grew those crops.

10. Some progress was made toward greater self-sufficiency in foods, even though per capita rice consumption steadily increased. Commercial policies and government attitudes toward foreigners made it easier to bring in needed chemicals and modern techniques. Supported by new monetary policies and institutional changes, rural credits for farmers increased 80%–or roughly 50% in real terms–during 1968-72. Together, these factors permitted an introduction of high-yielding strains on 18% of total riceland. This facilitated increases in rice yields averaging 6% annually during the period despite near-constant prices.

11. No particular program was instituted in the cities to increase incomes or employment. Nevertheless, encouraged by government policies, increased domestic and foreign investment boosted manufacturing and construction, which had stagnated during the Sukarno years. Growth in these industries, and the accompanying expansion of the services sector, provided many new jobs.

12. In short, the government learned much about the role of budgets and monetary policy in controlling inflation. Although it did not deal directly with the longstanding problem of realigning the domestic market in ways that would assure the most rapid and widespread growth, the overall economic stability and prosperity tended to have some positive effect on the living standards of many Indonesians.

Residual Problems

13. Despite the considerable economic gains in this period, relatively little headway was made against some basic problems that have plagued Indonesia throughout its history. Agriculture and food marketing remained splintered into largely isolated local markets because of both inadequate internal transportation and inept government pricing policies. The financing and implementation of public works and much-needed improvements in the educational system were severely inhibited by the weakness and lack of training of the bureaucracy. Extremely low salaries for government workers continued to encourage corruption, a problem as intense in Indonesia as in other nations of Southeast Asia. Heavy reliance on foreign technicians was not matched by a parallel effort to build up indigenous technical and administrative skills. In short, as has occurred a number of times in Indonesia, there was rapid growth in export lines and national output without commensurate diffusion of economic and social progress among the populace.

14. Although aspects of these problems could be cited in other LDCs, their sheer scale and intensity in Indonesia—particularly on Java—make them especially serious as sources of political ferment. Encouraged by visible signs of commercial progress, peasants swarmed into Jakarta throughout this period to help drive its population up some 1.3 million during 1967-72 and make it the fifth largest city in the developing world. Efforts to accelerate a rather limited birth-control program had little impact on a population growth rate of about 2.5% by the end of 1974.

Developments in 1973-74

15. The most prominent feature of Indonesian gains in 1973-74 was the rise in foreign earnings that accompanied the boom in the oil sector. Indonesia's net earnings from oil (see Appendix A) were up nearly 600% during the period. This was caused by dramatic price increases, a change in production-sharing arrangements that gave the government a larger share of the export revenues, and an output gain of 29%. Non-oil export commodities also benefited from strong world demand and high prices. Export earnings were supplemented by continued large-scale aid, and the net result was a 160% increase of foreign exchange reserves.

16. The rapid improvement on external accounts permitted greater government spending for consumption and development. Although budget data are still too sparse to trace the public sector's spending fully, there are some general

indications of how it was allocated. Pertamina,[1] an important contributor to development spending, was involved in a number of large projects in heavy industry and petrochemicals that absorbed much foreign exchange. Civil servants' salaries were increased at several intervals over the period. Food imports, primarily rice, were up dramatically as the government moved to build food stockpiles. Fertilizer imports, which the government subsidizes, also increased substantially.

17. The private sector was slow to catch up with the rapid pace of government spending. Consumption–in the national accounts sense–rose only 3% in 1973 but probably more than 10% in 1974 as income gains began to be distributed more widely. Imports of a variety of consumer goods increased almost 20% both years. With the exception of textiles, domestic industries producing directly in response to spending appear to have expanded considerably faster than during 1967-72. Foreign funds arrived in unprecedented amounts despite the student upset of January 1974 and boosted investment in manufacturing for the growing domestic market.

18. Even with this surge of spending and investment, the growth of Indonesian productive capacity substantially lagged the income gains. Rapidly rising food prices abroad and the weakness of the Indonesian central monetary system also contributed to inflation of about 40% during 1974. Consequently, stabilization policies re-emerged as key concerns for the first time since the immediate post-Sukarno days.

Growth in Real Output

19. Even discounting the distinctive feature of international gains, the petroleum sector continued to show rapid progress that only slackened in mid-1974. Crude oil production rose 23% in 1973 and another 4% last year (see Table 1). In 1974 the increase in earnings retained by the Indonesians in the sector was much larger than the production gain, however, because of new income-sharing arrangements with foreign oil companies concluded early in the year. For 1974 these factors resulted in net returns of \$2.2 billion from oil exports and receipts in kind–\$1.6 billion more than in 1973–thereby supporting a 30% gain in the contribution of the mining sector to GNP[2] (see Appendix B). Oil revenues were

1. Pertamina, Indonesia's state-owned oil company, has a monopoly over the refining and distribution of all petroleum products in the domestic market.

2. The impetus for growth on this order was present even before developments in the Middle East, but the dramatic series of price increases beginning in late 1973 caused some acceleration in exploration activities. Foreign oil companies spent nearly \$1 billion during the two-year period in addition to Pertamina's own outlay of more than \$500 million.

Table 1

Indonesia: Petroleum Production and Export Earnings[1]

	1970	1971	1972	1973	1974[2]
	Million Barrels				
Crude oil production	312	326	396	489	510
Exports	264	274	345	426	440
Crude	228	240	299	370	390
Refined products	36	34	46	56	50
	US $ per Barrel				
Average price of crude (f.o.b.)	1.69	2.08	2.87	4.00	11.92
	Million US $				
Value of oil exports	471	559	877	1,348	4,690
Net government receipts	158	205	330	565	2,194

1. Oil export data for a given calendar year represent earnings from shipments lagged by one quarter (see Appendix A).
2. Estimated.

sufficient to cover two-thirds of total government expenditures in 1974, compared with one-third in 1973.

20. Hard minerals–primarily tin, copper, and bauxite–also registered a strong performance in 1973, but this slowed somewhat in 1974 with industrial recession in the principal market, Japan. There were no new foreign investment approvals in mining during the period. Established foreign mining companies are, however, pushing forward with surveys, exploration, and development. Alcoa continued exploration and planning for a facility to produce 1.6 million tons of alumina annually from low-grade bauxite in East Kalimantan. The International Nickel Company began construction of a plant to produce nickel matte.

21. The importance of oil and minerals notwithstanding, agricultural performance remains the key determinant of Indonesian growth; gains here were encouraging. Favorable weather aided agriculture in 1973, and output increased 6% over the drought year of 1972. Growth was about the same in 1974. Rice production rose to 14.5 million metric tons in 1973 and reached 15.3 million tons in

1974. Production still falls short of domestic demand, however, and imports in both years were in the range of 1.2-1.4 million tons. Much of the imports went into building government rice stocks that had grown to 900,000 tons by October 1974, a vast improvement over 1972's low of 180,000 tons. The presence of these stocks and the general adequacy of market supplies kept retail rice prices[3] far enough below government ceiling prices[4] to curtail the need for market intervention.

22. The failure to achieve the goal of self-sufficiency in rice by 1973-74 was caused in part by the soaring price of fertilizer and other chemical inputs that, despite government subsidies, far surpassed concurrent increases in crop prices. The loss of incentive for the farmer to use chemical inputs meant that agricultural yields did not increase as rapidly as planned. Although the government imported about 600,000 tons in 1973 and another 1 million tons in 1974, the availability of fertilizer at the village level was hampered by distribution problems resulting from high transportation costs, poorly located market outlets, and untimely arrivals. In addition, government regulations often limited fertilizer use to certain crops and areas.

23. Yet some important steps are in train to increase yields. The support price of paddy was raised in April 1974 to help compensate farmers for the increased cost of inputs, particularly fertilizer. Another price rise went into effect in February 1975. In addition, government plans for increasing output should make Indonesia self-sufficient in fertilizer by 1980, even allowing for a 15% annual increase in consumption. Despite the technical problems involved, the government is also encouraging the establishment of capital-intensive rice estates by domestic and foreign private enterprise. Pertamina and two US companies are working on an estate in south Sumatra that will begin small-scale production in 1975, and according to present plans will be producing 300,000 tons annually by the end of the decade. Caltex is undertaking a feasibility study for a similar project in central Sumatra on a smaller scale.

24. The output of other domestic food crops, while stagnating in 1973, rose in 1974, spurred by higher prices and increased acreages and yields. BIMAS[5]

3. The price of rice is particularly important for stabilization efforts, as rice accounts for 30% of the cost-of-living index.

4. Recognizing the constraining effect of artificially low official rice prices on production, the government adopted a more flexible rice-pricing policy in late 1972 and has allowed the official ceiling price to rise gradually in keeping with market forces.

5. BIMAS is an agricultural extension program designed to help farmers obtain credit and improve their use of irrigation, fertilizers, high-yielding seed, and new agricultural techniques.

programs were extended to corn, cassava, soybeans, peanuts, cotton, and smallholder sugar crops. More attention was also given to improving fertilizer and insecticide distribution and to bringing more irrigated land into the program.

25. After years of stagnation, traditional export crops responded well to the boom in world commodity markets, which lasted through the first half of 1974. Rubber production, for example, was up 15% in 1973. To assure smallholders a share in the benefits of higher prices, measures were taken to organize farmers into project management units, to establish a nucleus system under which large estates would provide technical assistance to smallholders, and to establish rubber coagulating centers to process raw materials. The government also subsidized high-yielding seedlings for smallholders. Other export crops, including palm oil, coffee, tobacco, and copra, also registered increased output during the period.

26. The production of timber, the largest non-oil export crop, was up 25% in 1973, but growth slowed to around 5% in 1974. Causes of the slowdown included sharp declines in construction in the United States and Japan and excessive cutting in recent years. In response to both these factors, the government enforced reductions in output in the second half of last year, a move in keeping with the recent tendencies to discourage further foreign capital from moving into cutting and to restrict foreigners to joint ventures in processing.

27. Data collection on manufacturing industries is weak in Indonesia because much production occurs in small enterprises scattered outside the major cities. Progress during the period was not particularly impressive largely because of the sluggish performance of textiles; growth in 1973 was only 3%, with an upsurge to 8%-10% in 1974. Nevertheless, new capacity created in industries such as cement, chemicals, and vehicle assembly should pave the way for more rapid expansion of production in coming years.

International Payments Gains

28. The most striking feature in the 1973 international payments picture was the unanticipated boost to oil prices, a trend that greatly intensified in 1974. Oil accounted for almost half of Indonesia's export revenue in 1973 and climbed to more than two-thirds in 1974 (see Table 2). The volume of oil exports rose a dramatic 23%, to 426 million barrels in 1973. Shipments were slightly higher in 1974, but softening demand in the fourth quarter prevented a significant increase over the previous year's exports. Nevertheless, net oil receipts nearly quadrupled to

Table 2

Indonesia: Balance-of-Payments Summary

Million US $

	1972	1973	1974[1]
Exports (f.o.b.)	1,757	2,957	6,890
Oil	877	1,348	4,690
Non-oil	880	1,609	2,200
Imports (c.i.f.)	-1,403	-2,679	-4,320
Oil	-30	-43	-200
Non-oil	-1,373	-2,636	-4,120
Trade account	354	278	2,570
Invisibles	-832	-1,083	-2,761
Non-oil services	-315	-343	-465
Oil	-517	-740	-2,296
Foreign oil company profits	-300	-428	-1,038
Foreign production costs ("write off")	-117	-170	-675
Pertamina production costs	-100	-142	-583
Current account	-478	-805	-191
Private capital (net)	427	498	700
Direct investment (net)	258	290	455
Other	169	208	245
Official capital (net)	385	550	635
Loans/grants	447	624	735
Debt repayment	-62	-74	-100
Overall balance	334	243	1,144
Net errors and omissions	53	-10	-459
Change in official reserves[2]	-387	-233	-685
Yearend reserves	574	807	1,492

1. Estimated.
2. A minus sign indicates an increase in reserves.

$2.2 billion as the average price per barrel of Indonesian crude rose to nearly $12 from 1973's $4.

29. The spectacular petroleum developments tended to mask some sharp gains in other export lines, which rose above the $2 billion mark in 1974 despite the slowdown in the second half of the year (see Appendix C). Moreover, there were signs of some broadening of the export base, and investment in key resource areas brightened prospects for more rapid growth with industrial recovery in the developed world.

30. Imports (c.i.f.) reached $2.7 billion in 1973 and increased to an estimated $4.3 billion in 1974, reflecting buoyant domestic demand and high world

prices. Sharply rising capital goods and imports, particularly for petroleum production, and higher food and fertilizer prices were largely responsible for this trend. Also putting upward pressure on import expenditure was the acceleration of development project-related imports in the last quarter of 1974.

31. Net private capital inflows increased in both years. Direct investment in 1973 reached $290 million and was up to $455 million in 1974, despite new restrictions on foreign investment (see Appendix D). Much of this capital is associated with Pertamina investments, where the strictures relating to domestic equity participation or closure of certain sectors to foreign investment are likely to be ignored.

32. Official capital inflows were some 15% above the previous year's level. In 1973 the IGGI[6] pledged $840 million in aid to Indonesia; $624 million was spent by the end of December. Contrary to earlier expectations, foreign aid continued at a relatively high level in 1974, despite improvements in Indonesia's balance-of-payments and budget positions. Actual expenditures of IGGI aid in 1974 were an estimated $585 million, somewhat less than in 1973. However, disbursements under a Japanese government-to-government loan for development of the oil sector brought another $150 million, for a total of $735 million.

33. Indonesia paid $124 million on official external debts (principal and interest) in 1973 and was scheduled to pay another $145 million in 1974. The government has failed to respond positively to suggestions by its creditors that debt repayment be accelerated, so repayments will most likely continue to follow the schedule. Total public debt service[7] as a share of gross commodity exports was about 7% in 1974, down from 9% the previous year.

34. These payments patterns taken together netted foreign exchange reserves of $1.5 billion by the end of December 1974, an increase of $0.7 billion over 1973. Reserves of such magnitude–equivalent to about 4 months' imports–are a new phenomenon in Indonesia and will undoubtedly be a major factor in donors' aid decisions in 1975.

---

6. Intergovernmental Group on Indonesia (IGGI) members include Australia, Austria, Belgium, Canada, France, West Germany, Italy, Japan, the Netherlands, New Zealand, Switzerland, the United Kingdom, and the United States.
7. This includes repayments on public corporation loans as well as official government loans.

Inflationary Pressures

35. For the first time since 1968, inflation became a serious problem in 1973-74. Prices in Jakarta rose 32% and about 40% in these two years. Some of this was due to external factors. Inflation for Indonesia's trading partners, compounded by the effective depreciation of the rupiah relative to the yen, led to higher import costs. Import prices rose 88% between 1972 and the third quarter of 1974 as reflected in the following tabulation:

Index 1972 = 100

1973		1974	
I	110	I	155
II	129	II	181
III	140	III	188
IV	160		

Rice, fertilizer, and cement imports were among the items whose prices skyrocketed.

36. On the domestic side, inflationary pressures were intensified by rapid increases in credit to the private sector and state enterprises, which nearly doubled in 1973 and continued an upward trend in early 1974. The ultimate sources of these funds were increased non-oil export earnings and foreign capital. The latter was attracted to time deposits by high interest rates and the improved credit rating of private (and Pertamina) borrowers.

37. Domestic institutional factors also contributed from the supply side to inflation. As usual, goods shortages occurred in more remote areas because of inefficient local transportation; credit applications for small businessmen were delayed in administrative bottlenecks; and complex customs procedures often prevented imported goods from getting into the market on schedule. Corruption and bureaucratic ineptness were also important factors.

38. The various institutional impediments to price stabilization were similar to those Indonesia faced in the 1960s. What was distinctive about the 1973-74 case was that the source of much of the excess liquidity was not overworking of government printing presses, but the rapid net inflow of money from export earnings. New policies were required to deal with this new source of inflation.

Policy Formulation in the New Environment

39. Because Indonesia's financial position changed so rapidly in 1973-74, the government did not have time to adequately develop a concerted program to allocate its newfound wealth in a way that would best serve its three major goals: controlling inflation, reducing income inequality, and providing for long-term development needs. The policy mix adopted brought the economy a few steps closer to each goal but revealed that the government has yet to decide exactly what its priorities are.

40. The government, which still accounts for a remarkably small portion of national expenditures, proved inadequate to the task of acting as a conduit for the greatly increased export earnings. Despite planned 60% increases in both current and development budgets in 1974 and an 80% pay raise for government workers, the most notable event of the period was a shortfall in receipts in late 1974--and possible deficit--because of revenues withheld by Pertamina. Nevertheless, the government showed some capability in manipulating fiscal policy as demonstrated by increases in luxury taxes and cuts in taxes on mass consumption goods. In addition, the government pressured Pertamina to curtail its foreign borrowing and submit to closer scrutiny of its financial activities.

41. Pertamina, vaunted as an aggressive agent of development, expanded its extrabudgetary role with mixed consequences. With a company budget of $2 billion (roughly half the size of the combined current and capital accounts of the national government), it continued to move into housing, office buildings, hotels, roads, fertilizer plants, and metalworking plants. This further branching out, combined with cost overruns from inflation and a shortfall in projected 1974 oil earnings, resulted in a debt crunch with foreign creditors and a $560 million tax delinquency to the government.

42. A new monetary policy package directed toward stemming consumer credit expansion, increasing domestic savings, and controlling foreign borrowing was introduced in early 1974. Interest rates on savings deposits and for some state bank lending were increased. Credit ceilings were imposed on commercial banks. Reserve requirements for state and foreign banks were increased. Private enterprises were required to deposit 30% of all foreign loans in non-interest-bearing accounts with the Bank of Indonesia. Although these policies were correctly aimed at major sources of inflation during the period, they were difficult to enforce because the state banks are powerful enough to effectively circumvent the will of the central bank when they wish to do so.

43. The government chose not to appreciate the rupiah to promote increased imports. It continued to subsidize food and fertilizer imports, however, and attempted to streamline the customs bureaucracy to facilitate more rapid flow of imported goods into the country. Moreover, capital goods imports for development projects were accelerated during the last quarter of 1974.

Outlook for 1975-80

44. The economic outlook for Indonesia over the next five years or so appears bright. During 1975-76, the key stimuli for growth will be continued access to foreign capital and increasing domestic demand for foods and consumer goods. Thereafter, industrial recovery in the developed world should again provide the basis for rapid export expansion. With no sharp break in oil prices, Indonesia should enjoy foreign exchange revenues throughout the period that will permit average national output gains of 7%-9% (close to those of 1973-74). Significant as this performance may appear, it will hardly produce an affluent society; given the expected population expansion, per capita income in 1980 will be on the order of $200 to $225 (1974 prices), compared with about $150 at present.

Sector Performance

45. Some of the most important developments should occur in agriculture. After years of erratic support and uncoordinated intervention, the government has recently allowed greater play for market incentives. Without abandoning this new position, it will be taking on greater responsibilities for extension services and public investment to support farm production. Irrigation, new technology, and credit are being channeled to other crops after initial concentration on rice. Projects are in train to bring more land under cultivation in the outer islands and to develop a number of large rice estates. The government is expected to boost expenditures in transportation and communications to enhance domestic marketing. Moreover, domestic fertilizer production – primarily from Pertamina projects – will increase sharply in 1977 and should rise steadily for the next several years. By 1980, plans call for an increase of 20% in rice yields as a result of increased fertilizer application, double-cropping, and expansion of high-yielding varieties, which will make up close to two-thirds of total acreage, compared with one-third at present. World demand for food and other agricultural products should begin to rise after the current recession. On balance, these factors promise agricultural growth on the order of 4%-5%.

46. Although petroleum output is temporarily stagnating, there is every likelihood that it will shortly begin to move upward. The recent reef-type discoveries have the potential to push crude production up to 3 million barrels per day by 1980. The current world recession, conservation measures, and attempts to expand alternative energy sources by developed countries will limit demand in 1975. Subsequently, the Indonesian government will probably push production as rapidly as demand allows and is unlikely to participate in formal or informal prorationing schemes within OPEC. Similarly, the fact that oil company contracts in Indonesia allow the highest per-barrel return among OPEC countries virtually assures that the companies will be motivated to maximize production. Around 1978, sales of liquefied natural gas (LNG) will begin to add to petroleum earnings. A 20-year contract has been negotiated with a group of Japanese utility and industrial consumers for 400,000 barrels (crude oil equivalent) of LNG per day, worth some $22 billion (1973 prices) over the life of the contract. Annual growth of energy production during 1976-80 is not likely to fall much below 10% unless oil prices deteriorate markedly.

47. Manufacturing probably will grow faster than in any comparable period in Indonesian history. Foreign investment interest in non-oil projects showed no signs of flagging last year despite tightening of investment laws, as Japanese investment approvals alone increased $450 million, or 68% over 1973. Netherlands approvals also increased by roughly $100 million, and Hong Kong approvals rose to a total that rivals the United States for second place. Although US non-oil investment was down to one-fifth the average of the past seven years, this tends to overlook active negotiations for multi-million dollar projects in petrochemicals and mining. Government programs call for expansion of manufacturing on a wide scale. Toward the end of the 1970s, several large industrial projects are scheduled to come on stream, including fertilizer plants, petrochemical installations, oil refineries, and the country's first steel complex. A variety of installations also will be opening in processed foods, metal fabrication, finished lumber, and construction materials. In sum, the government looks for 13% average annual growth in manufacturing through 1980; allowing for the usual lags in implementing projects, an estimate of 10% is probably more realistic.

48. Other economic sectors will respond to this broad growth. Domestic commerce should prosper as output increases and transportation and communications facilities improve. The tempo of industrial construction will continue to boom, and there will remain a sustained demand for new office space and housing. Growth in services will most likely continue its present trend as incomes rise and increased urbanization affords more opportunity for jobs in the cities.

International Payments

49. We estimate that Indonesia will require average import growth of 20% (14%-15% in real terms) to achieve 7%-9% real growth in national output. Although this is roughly comparable to what occurred in 1967-72, programs to increase domestic production of some consumer and producer goods will allow the capital goods component to grow more rapidly than in the earlier period. Continued emphasis on food output, for example, will greatly reduce the need for food imports. Plans to expand capacity for fertilizer, cement, chemicals, steel, and sugar production will allow import substitution in raw materials and intermediate goods. The result will be capital goods imports rising at a rate of 30% (25% in real terms) or more, sufficient to support the projected growth path.

50. Indonesia should have little difficulty financing this growth of imports, even without concessionary aid. We expect rapid increases in both oil and other exports once recovery from the current global economic recession begins. The only reasonable contingency that could create serious balance-of-payments problems for Indonesia during the next few years would be a major break in oil prices. We do not believe such a break to be likely, at least through 1977; indeed, oil prices in 1976-77 are likely to increase at about the same rate as the prices of the goods Indonesia imports. Beyond 1977, prospects for the international oil market are much more uncertain; prices could decline, but, if OPEC sticks together, there would be strong incentives to push prices up further to relieve the growing balance-of-payments pressures on many OPEC countries, at least temporarily.

51. Table 3 presents what we believe to be a reasonable projection of Indonesian balance of payments through 1980. It shows continuing surpluses through 1979, with foreign exchange reserves building up to more than $4 billion, or more than two and one-half times the current level. A deficit is projected beginning in 1980, but only on the assumption that oil prices remain constant after 1977, while import prices continue to rise.

52. We project roughly a doubling of exports during 1975-80. Oil alone should bring in $9 to $10 billion by 1980, as production reaches some 2.2 million b/d.[8] LNG shipments, scheduled to begin in 1978, will further boost earnings. Non-oil exports, targeted for increased diversification in the current development plan, also have good prospects. The traditional raw material exports such as timber,

8. This output level is based on no increase in 1975, a 7% increase in 1976, and a 10% annual increase thereafter.

Table 3

Indonesia: Balance-of-Payments Projections[1]

	1974	1975	1976	1977	1978	1979	1980
				Million US $ in Current Prices			
Exports	6,890	7,440	8,810	10,160	11,710	13,210	14,750
Imports	4,320	-5,190	-6,240	-7,540	-9,020	-10,790	-12,920
Trade account	2,570	2,250	2,570	2,620	2,690	2,420	1,830
Invisibles	-2,761	-2,820	-3,030	-3,350	-3,690	-4,060	-4,470
Current account	-191	-570	-460	-730	-1,000	-1,640	-2,640
Capital account[2]	1,335	1,160	1,250	1,370	1,500	1,680	1,870
Change in reserves	685	590	790	640	500	40	-770
Yearend reserves	1,490	2,080	2,870	3,510	4,010	4,050	3,280
				Percent			
Inflation rates assumed for							
Oil exports		0	8	5	0	0	0
Non-oil exports		0	6	6	5	5	5
Non-oil imports		6	6	6	5	5	5

1. These projections are based on the following real growth rates:
   1. Oil exports: 0% in 1975, 7% in 1976, 10% thereafter.
   2. Non-oil exports: 0% in 1975, 5% in 1976, 10% thereafter.
   3. Oil imports: 0% in 1975, 7% in 1976, 10% thereafter.
   4. Non-oil imports: 15%.
   5. Oil invisibles: 0% in 1975, 7% in 1976, 10% thereafter.
   6. Non-oil invisibles: 11%.
   7. Official capital: -30% in 1975, 0% thereafter.
   8. Private capital: 15%.
2. Including debt service payments.

rubber, and hard minerals will expand steadily, especially in view of previous Japanese and US investment in these areas and Indonesia's reputation as a reliable supplier in both these markets. Light manufactures, chemicals, new food crops, and processed fish are among product lines likely to grow more rapidly in coming years.

53. Official capital inflows will most likely level off at about $500 million annually. Traditional donors will probably decrease their lending to the $300 to $350 million range in response to Indonesia's improved financial conditions. Most

new loans are assumed to take the form of credits from official export banks abroad and to be largely on commercial terms. The remaining $150 to $200 million will come from drawdowns in the IGGI aid pipeline. Although there has been much discussion of development loans with the Soviets and East Europeans, no significant commitments have yet been made and such amounts as are received from the Communists in this period will likely remain modest.

54. Outside of the oil sector,[9] private capital inflows should be up about 15% annually, in line with import growth. Although the projection appears conservative in view of the 1967-72 average increase of 50%, total foreign investment in Indonesia has already reached a high level -- more than $1.5 billion -- and the capital-intensive mining and forestry sectors are now being closed to foreigners. Future private funds will probably be drawn to joint ventures in manufacturing and medium-term loans for development projects in such areas as transportation, communications, real estate, and utilities. Despite new, more stringent foreign investment regulations, the government will continue to court foreign investors to help support its ambitious development plans.

Development Consensus and Strategies

55. Within these broad themes, the particular course taken by the economy over the next several years will be strongly influenced by the ways in which the Indonesian government adjusts to its new gains. Even this year, with foreign exchange reserves up sharply and the volume of imports growing rapidly, Jakarta is preoccupied with an anomalous short-term foreign debt crisis at Pertamina that can only serve to remind the Suharto administration of how recently the country has recovered from the chaos of Sukarno. Spurred by these reminders and by shrinkages in official aid from the IGGI, senior officials can be expected to continue major efforts to drum up support abroad among Communist and other non-traditional donors, and they will behave for some time in ways that highlight the nation's underlying poverty rather than its recent additions to earnings.

56. As the Indonesians become more accustomed to sustained growth and greater financial flexibility, various factions will begin to focus on particular development strategies. For the moment, rapid development through

9. In keeping with accounting conventions, oil sector investment, which automatically reverts to Indonesia and is written off by the foreign companies when production begins, is included in the invisibles account in the projections in Table 3.

capital-intensive resource investment has captured the attention of most politicians, planners, and Pertamina officials. If present advisers remain close to Suharto, the emphasis on development through this route is likely to continue, qualified only by the concern that foreign exchange holdings be kept fairly high.

57. There will probably continue to be some social unrest. Rapid growth in manufacturing and services and increasing productivity in farming will continue to encourage further migration of unskilled workers to urban areas. Consequently, the slum population of Jakarta and other cities will grow steadily, providing a stark contrast to improving living standards among employed workers. The most serious disturbance in recent times has come from student agitators, who with other pressure groups can be expected to exploit the income gap through demonstrations and other political activities in coming years. Nevertheless, so long as the top military leadership maintains its present consensus on goals and methods, the Suharto regime should have sufficiently strong hold on domestic order to assure that these intermittent pressures will not significantly alter national economic policy.

APPENDIX A

OIL SECTOR BALANCE OF PAYMENTS

Table A-1 is a summary of available information on Indonesia's oil sector balance of payments. [redacted] 25X1 25X1 xport revenues are calculated in gross terms, while company profits and production costs are treated as foreign exchange expenditures.

Table A-1

Indonesia: Net Receipts from Oil Exports

	Million US $	
	1973	**1974**
Gross oil exports	1,348	4,690
Oil imports (c.i.f.)	-43	-200
Invisibles	-740	-2,296
Foreign oil company profits	-428	-1,038
Foreign oil company production costs	-170	-675
Pertamina production costs	-142	-583
Net oil exports (net foreign exchange receipts from the oil sector)	565	2,194

Oil exports are estimated on a payments basis, assuming an average lag of three months from shipment. Thus they represent shipments during the first three quarters of the year and the last quarter of the previous year. A further, more irregular, lag can occur when Pertamina falls behind schedule in transferring its tax payments to the central bank. This can cause discrepancies between Indonesia's actual foreign exchange reserve position and the reserve position implied by the current and capital accounts. For example, on 31 December 1974, Indonesia reported $1.492 billion in official reserves, whereas known data would have suggested a figure closer to $1.8 billion. The "missing" funds are very difficult to trace, but for accounting purposes are shown in the net errors and omissions account of Indonesia's balance of payments. Most of the problem is Pertamina's occasional difficulty in meeting demands from foreign creditors on its income, and the company has been using some of these funds to roll over short-term debts.

APPENDIX B

NATIONAL ACCOUNTS DATA FOR 1974

Because output data on Indonesia are somewhat sparse and slow in appearing, it was necessary to estimate national accounts for 1974 (see Table B-1). For most sectors, this required only a relatively straightforward extrapolation of the output series and other statistical indicators. In the case of petroleum, the increase in Indonesia's share of earnings and the corresponding decline in the foreign companies' share result in a much larger growth of the contribution to gross national product, which excludes the earnings of the foreign companies, than to gross domestic product, which includes these earnings.

Table B-1

Indonesia: GNP Growth by Sector

Percent

	Sector Share					Average Annual Rate of Growth				
	1969	1970	1971	1972	1973	1970	1971	1972	1973	1974[1]
GNP	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**7.5**	**7.0**	**6.9**	**8.2**	**8.8-10.3**
Agriculture	49.4	47.8	46.4	44.3	43.2	4.1	3.8	2.1	5.6	5-6
Mining	4.4	4.9	4.8	5.6	6.3	17.5	5.5	23.1	23.2	30
Manufacturing	8.9	9.0	9.6	9.4	9.0	9.7	13.5	5.2	3.3	8-10
Construction	2.3	2.7	3.0	3.4	3.9	25.6	18.4	22.2	22.7	20-25
Transportation	3.1	3.1	3.6	3.9	3.4	5.5	26.4	13.6	11.3	5-10
Trade	16.9	17.7	17.8	19.1	19.7	12.8	7.8	14.8	8.0	10-15
Services	5.7	5.5	5.3	5.0	4.7	2.7	2.6	2.5	3.1	4-5
Other	9.3	9.3	9.5	9.3	9.8	8.8	9.0	6.9	6.5	10-12

1. Estimated.

Overall Growth

GNP probably grew 8%-10% in real terms, slightly above the 1973 rate because:

- agriculture again performed well;

- the mining sector expanded at a record 30%, with unusual changes in production-sharing; and

- other sectors and services expanded in response to higher oil and farm output.

Sector shares were derived from available production and national accounts data; the methods used to estimate the growth rates of various components of GNP are described below.

Agriculture

Agriculture grew an estimated 5%-6% as it did in 1973. Rice production was up 5%-6%, other food crops continued to recover from the drought and to make gains under agricultural improvement programs, and timber output rose about 5%.

Mining

Driven by petroleum earnings, this sector grew 30%. About 5% of the growth reflects increased oil output; the other 25%-30%, contract revisions that allow more of the oil profits to accrue to Indonesia. Other mineral production also expanded 5%-6%.

Manufacturing

A growth rate of 8%-10% in manufacturing was led by gains in the production of fertilizer, assembled vehicles, and auto parts. A slowdown in textiles prevented more rapid overall expansion in the sector. Growth in import volume for the first half of 1974 – 40% – suggests that Indonesian producers are not encountering significant difficulties in gaining access to raw materials and capital equipment.

Construction

Sustained demand for new buildings, factories, and homes should have kept the construction industry growing at 20%-25% as in 1973.

Transportation

Transportation probably again grew in the 5%-10% range because of expanding production of motor vehicles and increasing emphasis by the government on improving local transportation systems.

Trade

Rapidly increasing imports and strong demand should have supported trade growth of 10%-15%.

Services

Services are estimated to have grown 4%-5%, slightly more rapidly than population, in support of growth in other sectors.

Other

This sector is estimated to have grown above trend at 10%-12% as its main components, banking and public administration, expanded in response to increased financial activity and higher government salaries.

APPENDIX C

NON-OIL EXPORT COMMODITIES

Non-oil exports in 1974 climbed an estimated 35%, following an 85% rise during the previous year. Most of the increase was caused by higher prices as commodity markets remained relatively buoyant, but many products registered volume increases also (see Tables C-1 and C-2).

Table C-1

Indonesia: Non-Oil Exports

	Million US $			Percent of Total Exports, 1974
	1972	1973	1974[1]	
Total[2]	880	1,609	2,200	100
Timber	229	574	733	33
Rubber	190	392	500	23
Tin	70	93	162	7
Copper	5	64	142	6
Palm oil	41	70	140	6
Coffee	77	78	108	5
Tea	31	26	41	2
Tobacco	30	40	34	2
Pepper	22	29	27	1
Copra cake	13	17	24	1
Bauxite	6	7	12	1
Palm kernels	4	5	10	Negl.
Copra	4	5	....	....
Other	158	209	267	12

1. Estimated.
2. Because of rounding, components may not add to the totals shown.

In 1972, ***timber*** became Indonesia's second largest export; it retained the position in 1974, as export earnings more than tripled the 1972 level. The boom was caused by sharp price rises resulting from the revival of Japanese demand, increased US demand, and improved quality control. When demand tapered off in the second half of 1974, prices fell, but not enough to offset gains earlier in the year. Such spectacular growth is not likely to continue throughout the decade, as sharp demand increases would be hard to sustain. In addition, the government

Table C-2

Indonesia: Non-Oil Exports[1]
1974

	Thousand Metric Tons[2]	Price per Unit (US $)	Million US $
Total[3]			2,200
Timber	18,800[4]	39	733
Rubber	800	625	500
Tin	24	6,835	162
Copper	237	600	142
Palm oil	280	500	140
Coffee	115	940	108
Tea	50	816	41
Tobacco	34	1,000	34
Pepper	17	1,588	27
Copra cake	220	109	24
Bauxite	1,200	10	12
Palm kernels	29	345	10
Other	N.A.	N.A.	267

1. Estimated.
2. Unless otherwise noted.
3. Because of rounding, components do not add to the total shown.
4. Thousand cubic meters.

already has plans to follow the lead of the Philippines and Malaysia in restricting cuttings and promoting log processing. The market for processed lumber is a much more competitive one in which Indonesia, at least in the short run, will not have an advantage.

After a long period of stagnation, ***rubber*** exports revived in 1973. This was caused mainly by the doubling of prices, although production expanded 15% as it became profitable to tap older trees. The revival was slowed by falling prices in the second half of 1974, but earnings still were up nearly 30% during the year. Recent growth in production has come from smallholders, who produce 70% of Indonesian rubber. Through the rest of the decade, estates will play a greater role in growth as more attention has been given to their rehabilitation.

Palm oil and kernels are produced only on estates, both government and private. Production was up in 1973 as crops recovered from the 1972 drought and acreages expanded in response to improved world markets. The value of palm

oil exports increased 70% in 1973 and doubled in 1974 as prices remained high. Palm kernel exports will continue to taper off because the kernels are being used domestically in the new crushing mill that opened in October 1973.

Coffee, primarily Robusta, is grown on estates and small farms. Production has recovered from the drought of 1972 and increased slightly in 1973. High prices continued to boost export receipts in 1974, but the volume of exports remains constrained by the slow growth in world demand.

Tobacco production and quality were adversely affected by drought in 1972 and heavy rains in 1973. Some improvement in 1973 was due to the expanded use of fertilizers, improved seed, and irrigation, combined with better weather. Export volume was about the same as in 1973.

Pepper exports have stagnated in recent years because of lack of maintenance, fertilizer, and credit and of vulnerability to disease. Export earnings in 1974 dropped slightly. Planned rehabilitation of the pepper industry should result in export increases in keeping with world market growth of 2% per year by the end of the decade.

Production of *tea* is expected to remain constant for the rest of the decade. Three estates are being rehabilitated, but output on others will continue to decline. Export earnings will depend on world prices, which rose at the end of 1973 and remained relatively high to increase earnings by nearly 60% in 1974.

Copra production has been hampered in recent years by drought, pests, and aging trees, but there was some recovery in 1974. Exports of copra have been banned since October 1973 because shortages on the domestic market were causing severe losses for processing mills and driving up the price of coconut oil. *Copra cake*, on the other hand, will continue to be exported and take advantage of higher prices.

The state *tin* enterprise, currently the sole producer in Indonesia, is pursuing a vigorous policy of expansion and rehabilitation. Production was up 5% in 1973 and another 10% last year. Processing capacity is also being expanded, and by the end of 1975 Indonesia may be exporting only tin metal. High prices and the end of the International Tin Council quota system should continue to boost export revenues, which were up an estimated 75% in 1974.

Freeport Indonesia, Inc., began exporting ***copper*** concentrates from Irian Jaya in October 1972. The volume of exports in 1974 reached 237,000 tons, double that of 1973. High prices, especially during the first half of the year, brought an even greater increase in revenues.

Other non-oil exports, mainly corn, cassava, soybeans, livestock, and fish, accounted for 12%-18% of the total during the period. The government plans to further diversify non-oil exports in coming years, with emphasis on capturing markets for petrochemicals and light manufactures.

Even with the projected improvements in the traditional export commodities, it is clear they will lag behind the more dynamic oil, mineral, and timber sectors. This has definite implications for employment and income distribution. A large portion of the rural population depends on the production of the older labor-intensive commodity exports for its livelihood. New jobs in expanding capital-intensive sectors cannot fully absorb the large number of rural unemployed from the slow-growing traditional export sector, providing yet another obstacle to narrowing the gap between rich and poor, which is a primary goal of the Indonesian government for the present five-year plan (April 1974-March 1979).

APPENDIX D

NEW FOREIGN INVESTMENT POLICIES

Three new pronouncements affecting the foreign investment climate in Indonesia were issued last year by President Suharto. Initially, there was confusion within the government and among existing and potential foreign investors, but now it appears that the new rules will not markedly discourage the inflow of private capital.

In response to strong pressures to increase indigenous ownership in foreign corporations, the following principles to guide foreign investment were announced on 22 January 1974:

- all foreign investments should be in the form of joint investments with Indonesians,
- the share of ownership by Indonesian nationals in foreign enterprises should be increased gradually to 51%,
- the list of industries closed to foreign investment should be extended,
- the tax incentives given to foreign investors should be reduced, and
- the number of foreigners employed in foreign enterprises should be kept at a minimum by instituting training programs for Indonesians.

Thus far, there are few specific plans for implementing these principles. The government hopes to spread the benefits of ownership gradually through intermediary trusteeship or escrow arrangements or by transferring shares to retirement or welfare funds that benefit indigenous groups. Some tax arrangements have been changed: Freeport Indonesia, for example, has had to shorten its tax holiday from three years to one year. Such moves, however, do not appear to be widespread. Suharto admits privately that he does not want to make foreign elements feel threatened or to hamper development. Rather, he wants the critics of foreign involvement in Indonesia to know his intention that the fruits of business be shared more equitably.

On 26 March 1974, the government announced that a $100 per month head tax would be imposed on each expatriate employee of foreign businesses that are

not meeting their obligations to hire and train Indonesians. Although it has been interpreted more widely by foreign investors, this regulation is meant to apply primarily to forestry in which more than 10,000 foreigners work. The real offenders, however, are not foreign-owned logging companies but Indonesian concessionaires who turn over their tracts to Filipino, Malaysian, and Singaporean contractors who hire few Indonesians. All foreign investment agreements contain a detailed schedule for replacement of expatriates by Indonesians; most companies are adhering to these schedules. Political pressures, however, have recently encouraged the government to convey the impression that foreign investors are breaking the rules.

The third new regulation concerning foreign investment was among the anti-inflation measures of 9 April 1974. The requirement that 30% of certain funds borrowed from abroad must be deposited in non-interest-bearing accounts was aimed chiefly at foreign companies. This measure undoubtedly had some effect on stemming credit expansion, but was dropped in late 1974 when inflationary pressures abated.

The consensus seems to be that most foreign investors have not been put off by the new laws because they do not expect them to be strictly enforced. There is a widespread belief in the corruption of government authorities and the official acceptance of pay-offs as the normal way of doing business. Indonesian businessmen are readily available to front for foreign investors to give the appearance of majority Indonesian ownership. Unless potential investors are given more substantial cause to change their perceptions, they will continue to bring their business to Indonesia.